

## CURRENCIES AND CREDIT MARKETS

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The upswing of the last trade cycle is brought about by an expansion of credit and lasts so long as the credit expansion goes on or, at least is not followed by a credit contraction. A credit expansion is brought about by the banks through easing the conditions under which loans are granted to the customer."

Gottfried Haberler, Prosperity and Depression, 1937  
Edition 1964, p. 17

### HIGHLIGHTS

Speculative bubbles are starting to burst. The evidence is everywhere. Could recent tremors be foreshadowing more colossal events ahead?

The dollar has entered an extremely perilous phase. It has yet to be explained how a deficit country over the long run can live with the lowest interest rates in the world and still have a strong currency.

We analyze all the arguments pushed in favour of a dollar recovery including the PPP theory. None of them stand up. For one, we don't see how the large dollar-DM interest rate gap can narrow anytime soon.

The most important prop for the U.S. dollar must come from an economic recovery. Again, as we have so many times in the past, we search vainly for the foundations of a robust recovery.

The main causes of the U.S. and other Anglo recessions — a profit and income squeeze and overindebtedness — are not being resolved. The consumer needs a rapid increase in purchasing and spending power but rising income and credit growth are missing.

To a large extent, the corporate sector holds the key for recovery. We review recent financial developments. To us, corporate trends suggest retrenchment and a serious risk that investment weakness will eventually add to further employment and consumption weakness.

Accelerating money and credit growth is an absolutely indispensable condition for any recovery. There's never been an exception. And here, conditions are going from bad to worse.

The persistent weakness of money and credit tells us that the monetary easing is fizzling out in the financial system without reaching the real economy. What counts is the amount of money that the banks actually put into circulation by lending, which is near nothing currently.

In the meantime, ever lower interest rates triggered due to sluggish growth continue to fire up securities markets. This decoupling of the financial markets from the underlying economy can only go on so long. Financial markets, therefore, remain horribly overvalued and vulnerable.

More than ever, investors should ignore all the short-term market hype. Stay with bonds denominated in hard-currencies. They've already begun to prove their worth in recent months.

## **CRACKS AND CRUMBLES**

All of a sudden, things are beginning to happen . . . a little tremor here, a bigger tremor there. An ominous sense of anxiety and puzzlement is starting to unravel world capital markets.

Economic trends in the Anglo countries — especially the U.S. recently — and Japan continue to disappoint. Stock portfolios are down almost everywhere. Despite still relatively healthy index levels in the U.S., over 50% of listed stocks are down more than 30% since the beginning of the year. Another rally effort in the Japanese stock market (now down over 60% from its 1989 top) has again succumbed to new lows. Hyped-up stock markets in South America and Asia have been capped, marked by Mexico's tumultuous tumble of over 17% last month. And, Europe's high-yielding bond markets — Spain, Italy, and ECU — have fractured under recent EMU uncertainty. The wisdom of investing in the bonds of hard currency countries is now being borne out.

The greatest sign of distress, though, is the dollar; a reflection of yet another still-born economic recovery. The dollar's gradual downtrend has turned into a rout again defying the near-unanimous siren calls of the global brokers and analysts. Rather than lofting to DM 1.80 or higher, it recently sagged to DM 150 under the weight of yet another panicky discount rate cut.

At first blush, most of these events seem unrelated. To the contrary, we think. They all have one thing in common: speculative bubbles are starting to burst. Naturally, many people are beginning to wonder whether this might be the start of something more epic.

## **THE BIG SHOCKER**

The most shattering news for markets was the May plunge in U.S. employment, the sharpest fall since November of 1991. In addition, the average work week dropped by 0.3 hours. Most revealing was another drop in manufacturing employment (down 58,000 jobs), now at its lowest level since 1982 after having fallen continuously since 1990. This news, in our view, virtually seals the fate of the U.S. recovery, the stock market, and the dollar.

Promptly, on receipt of the dour news, the Fed cut the discount rate a half percentage point from 3.5% to 3%. We have never doubted that there would be another interest rate cut eventually. The only thing of curiosity to us was how financial markets would react this time — positively or negatively. A critical observer could have argued long ago, that rather than guaranteeing a new cycle of prosperity, every new discount rate cut is another admission of weakness, that previous cuts have failed, and that the Fed is worried. So far, every cut was met with joyous anticipation and celebration in the financial markets.

This time, given the stark and unexpected weakness of the statistics, the reaction was not so surprising perhaps: it was disbelief rather than shell-shock. Analysts were quick to counter the data saying that it was inconsistent with other statistics. Admittedly, employment numbers are volatile, but we see the report as being perfectly consistent with other data: notably, federal receipts from individual income taxes have weakened, every economic demand sector has softened, and most ominous of all, extreme weakness in the monetary data. Taken together, it raises the spectre of a triple-dip recession.

## **ECONOMIC RECOVERY: MISCONCEIVED FOUNDATIONS**

During the last one or two years, international investment has been heavily influenced by two popular perceptions: the belief that the U.S. dollar is grossly undervalued against the D-mark and the yen and that

it therefore could only go up over the longer run; and second, concerning European bond markets, was the plausibility of the so-called convergence theory. The latter argument held that interest rates of the member countries should converge down to the level of the lower-rate countries since currencies were fixed within the European exchange rate mechanism (ERM). Adherents to this view complacently bought high-yielding European bonds — Italian, Spanish, British and ECU — anticipating that their yields would fall to German levels, and in the process, serve up quick and handsome capital gains.

We have always been at loggerheads with both of the above views, insisting that the best conventional, low-risk investments — particularly for dollar-based investors — were European hard-currency bonds. In direct contrast to the bullish consensus, we saw the U.S. dollar mired within a long-term "bear" trend.

Secondly, we have always regarded the "convergency theory" as highly defective . . . actually, insane. It was always clear to us that the excessive capital inflows into these soft-currency countries driven by the short-term interest rate speculation essentially had the destructive effect of stoking up inflation and checkmating their anti-inflation policies. In the end, the result was actually divergence rather than convergence. We never doubted that one day there would have to be sharp corrections both in exchange rates and bond yields. Besides, given the high risks of the times, one really couldn't ask for much more than the relatively rich 8-9% yields in hard-currency bonds.

### **THE SAGA OF THE DELAYED DOLLAR RALLY**

Really, just how weak is the dollar? Could it suffer a break to new lows — lower than DM 1.44? Though the dollar bulls are more than surprised by the currency's new weakness, we still see them clinging doggedly to their conviction that the dollar, like the Phoenix, will rise again. Most analysts continue to predict that the dollar's take-off, which they have been predicting since early last year, has only been delayed and downsized, not aborted. Hopeful market sentiment still prevails and weakness is generally presented as a "buying opportunity."

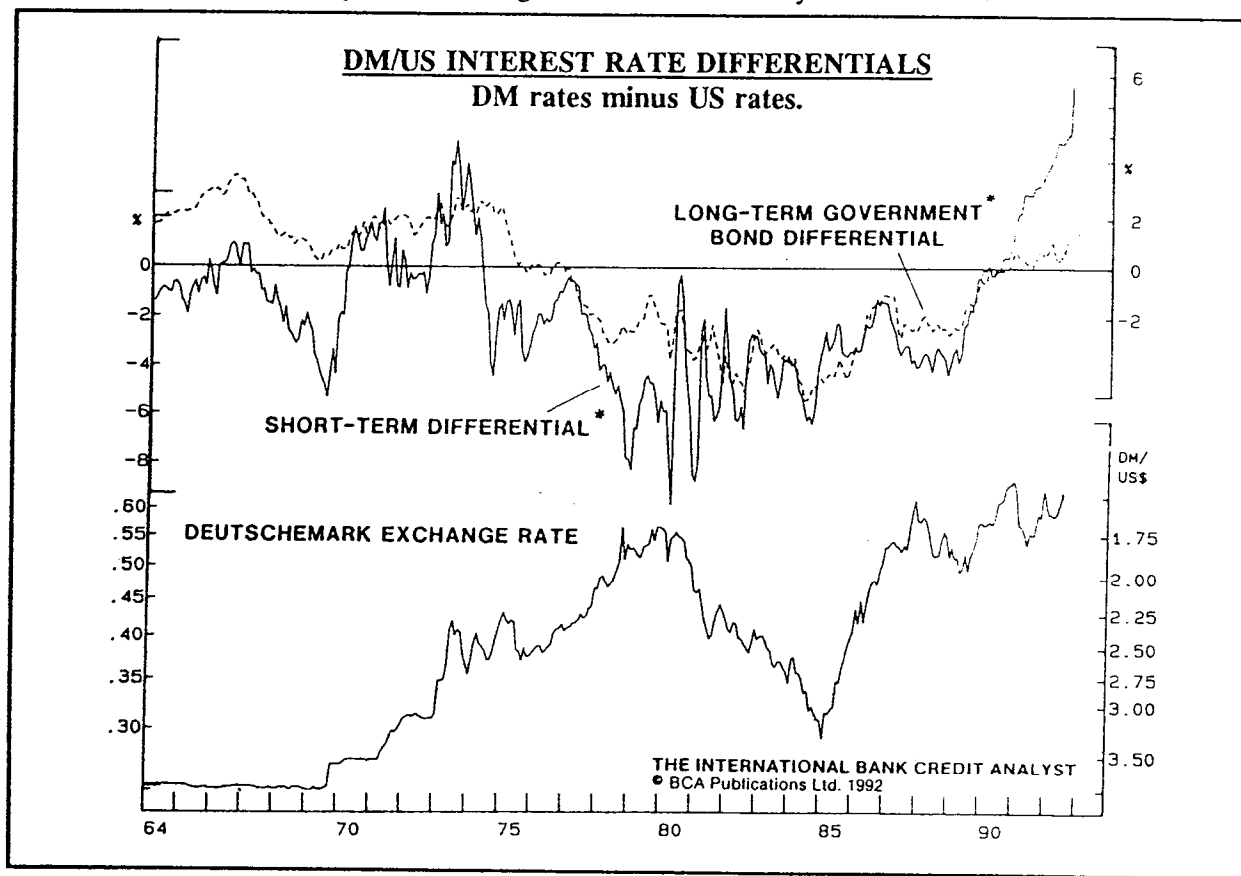
Thinking back over the last few years, it strikes us just how unbelievable and frantic the antics of the whole dollar saga have been. One psyched-up, manipulated rally after another has fallen into the ashes, often hitting new lows. The script for the dollar's 1992 bull-run was a virtual rehash of last year's misguided forecasts. The dollar again soared in anticipation of an imminent U.S. economic recovery that would cause the Fed to tighten, while expecting that German interest rates would fall due to an encroaching recession there. It was, to be sure, a speculative bubble. As the huge U.S.-German interest-rate gap would soon narrow, so the conclusion went, strong global portfolio shifts into dollar assets would boost the dollar.

To us, not one single assumption in this dollar bull story ever made any fundamental sense. It's only elemental to realize that before higher dollar interest rates can begin to pull in capital from abroad, that an U.S. economic recovery is required that's strong enough to justify a material monetary tightening. For reasons often explained, we never saw the possibility for such an U.S. economic recovery.

Above all, however, apart from the constant drum beat calling for a dollar rally, we wonder just what's so alluring to foreign investors about dollar asset: U.S. real estate is an unmitigated disaster area and remains far from a turnaround; U.S. bond yields are among the lowest and least supportable in the world. If the recovery would have materialized, yields of course would have risen kicking up capital losses for the holders of long-term bonds. If alternatively, and as we thought, the Fed would have to ease further

in response to a weakening economy, it may be helpful for U.S. bonds but it definitely would be poison for the dollar. The bondholder would likely lose again.

The same considerations apply to U.S. stocks, only here, risks are much higher than on bonds given the dizzying valuation levels. U.S. stock markets are now the most expensive of the major world markets, and by some measures are even dearer than Japanese stocks. Is it at all plausible to believe that foreign capital inflows into dollar-based assets will drive up the dollar? We think that the major risk entails exactly the opposite. A significant slide on Wall Street, once it develops, will add to the dollar's downward pressure. Money will be racing for the exits and away from the dollar.



### CRACKS IN THE DOLLAR'S FACADE

The dollar has entered an extremely perilous phase. Waning confidence in an U.S. economic recovery has fractured the earlier expectations of rising U.S. interest rates. The Fed's recent half-point discount rate cut has only added to the perception of weakness. Considering the dollar's all-time record, short-term interest rate disadvantage of 6% and more against the European currencies (see the graph above), even in light of its recent weakness we have to admit that dollar has held up astonishingly well. But while speculators and traders may tend to overlook such a huge yield gap when a dollar rally seems under way, dollar speculation is becoming more painful and expensive as the prospect for an economic recovery fades and squashes hopes for the dollar's rally.

No question, the U.S. economy's strength/weakness is presently the key factor for the world economy and world markets — stocks, bonds, currencies and commodities. It has been a central assumption among policymakers and forecasters worldwide that an U.S. economic recovery will pull the world economy out of its slump. But, again, after a brief head of steam so far this year, the U.S. locomotive is rapidly losing speed. It's quickly becoming clear that the economy's apparent ground swell has been attributable to nothing more than statistical optics and the one-time income transfer measures contained in this year's February budget.

For the time being, the consensus clings to the hope that the U.S. economy will continue to grow, though slower than anticipated. As usual, Wall Street was quick to discover the sunny side of slow growth declaring that slower growth is actually more pleasurable. It would really be the best of all worlds for the financial markets, since inflation and interest rates would stay low, yet allow rising business profits and securities prices. And, because the recovery was starting so slowly — pacing itself like an endurance runner — it would last longer.

One problem with these merry conclusions is that the currency market, as is plainly obvious, thoroughly dislikes this outlook.

### **THEORETICAL UNDERPINNING FOR A RECOVERY**

Economic consensus has come full circle: from the former "soft landing" arguments of 1988-1989 to the "soft recovery" story of 1991-92. When it comes to invoking rosy scenarios, Wall Street is truly unbeatable, and for that matter, so are the London brokers. Unfortunately, the only thing soft about these scenarios is the logic. A "soft recovery" is bound to abort rather sooner than later. Self-sustaining recoveries always proceed right from the start in a progressive and self-reinforcing fashion. Hiring begets output and income; income begets spending; spending begets output; and output begets hiring and investment in a cumulative cycle. It is this regular cyclical dynamism — income and money growth being most noticeably absent — that is failing to catch in this U.S. economic recovery.

So far, most reports about the U.S. economy still sound pretty optimistic and, in general terms, imply that the recovery is continuing to broaden, though at a more moderate pace. But the statistical details tell the exact opposite. More and more economic numbers recently have black minus signs in front of them signalling a broad weakening of nearly all components of final demand — consumption, fixed investment and exports. The same phenomenon is found in Canada and Britain and other countries to a lesser or greater extent. In Britain, profits and dividends continue to crash under the weight of an unshakable recession that has now lasted more than eight quarters. The same is true in Canada.

The prevailing view is that the consumer will lead this U.S. recovery. In fact, the consumers appear to have done just that in the first quarter. Real personal consumption expenditures rose 5% during the quarter or \$40 billion at an annual rate, compared with total GNP growth of 2.7% or \$32 billion. Since February, however, consumer income and spending growth have stopped dead in their tracks. After having increased at a 9.5% annual rate in the first quarter, real retail sales have since declined at a 6% rate, versus a 6% increase in industrial production.

To lead the U.S. economy out of its "growth recession," as many assume, the consumer would need rapidly increasing purchasing and spending power. That can only come from income or credit growth. As a rule, it was always a cumulative interaction of the two that drove former recoveries. But this time,

both are missing. Record-low credit growth obviously undermines the other.

### **HEAVE-HO THE CONSUMER**

Just what can break this self-perpetuating circle of consumer retrenchment? First, the government could stoke consumption by slashing taxes and boosting expenditures; second, businesses could do so by increasing employment, production and investment; and thirdly, but less sustainably, a decline in the personal saving rate could give a temporary boost. This last measure, if consumer confidence would allow, doesn't have much of a chance in the U.S.; the savings rate, presently at 5.2%, has yet to recover much above secular lows. At least in Britain, the savings rate has risen steeply to a recent high of 11.5%. As to the first measure, surging deficit spending has already given the economy a powerful boost recently, but only temporarily. Because of the existing size of the deficit, the fiscal stimulus cannot be maintained. Apparently, the effects are rapidly petering out.

In the last analysis, the potential for the U.S. recovery crucially depends on the health of the corporate sector as a pre-condition for rising production and rising consumer incomes. Consumers' buying power moves up or down mainly in tandem with changes in the rate of production as it increases or decreases the current flow of wages and salaries. To a large extent, the corporate sector holds the key for recovery. Just what chance is there that the corporate sector might carry the day?

### **CORPORATIONS TO THE RESCUE**

Recessions are the periods in which businesses cut their costs and reliquefy their balance sheets before they embark on the next expansion. Accordingly, we have been focusing on these two effects, to determine whether or not the U.S. corporate sector is really ready for a recovery.

There are clearly two important positive factors at work. U.S. businesses have sharply stepped up their bond and stock issues. The Fed's latest flow of funds accounts (the only comprehensive source for this data) show that U.S. corporations in the first quarter of this year raised — all figures annualized — \$51 billion of equity and a total of \$80 billion in bonds. In all of 1991, for comparison, total net issues of bonds and stocks amounted to \$96 billion.

The rise in the tide of bond and stock issues raises two interesting questions: first, what is this inflow of funds being used for; and second, how do these financial operations impact the money aggregates. There is a widespread, comforting view that this healthy shift in financing is a major explanation for the persistent, unusual weakness in bank credit and money supply.

No doubt, the high securities issues play a role in slowing the money supply to the extent that the proceeds are used to repay bank loans. But the really decisive point to see is that total business borrowing has virtually collapsed to a near-zero pace as compared to a growth rate of around 10% during the recession years of 1980-82 . . . that being well before the big borrowing binge for takeovers that began later in the decade. Altogether, cash flow from internal and external sources is down sharply from its peak in 1988. But since capital outlays have fallen even faster, liquidity has been improving.

To complete the picture, it should be added that America's corporations have found a brand new application for their liquid funds. No, it isn't productive investment. Since the second quarter of 1991, non-financial corporations have been buying unprecedented quantities of government securities.

Earlier, we asked the question whether or not the U.S. corporate sector is ready for a recovery. While the answer is difficult to quantify, we think that these flows and uses of corporate funds certainly don't indicate an expansive strategy. We would say that they suggest retrenchment and a serious risk that investment weakness will sooner or later add to employment and consumption weakness.

Why this corporate retrenchment? Weak balance sheets aren't the only cause. There is a second major reason: weak business profits. At the root of all this "restructuring," "downsizing" and labour-shedding is a desperate struggle for profitability. It's not just the mere availability of credit that induces new investments, but rather the expected profitability. Let's, therefore, have a look at whether or not the prospect of business profits gives encouraging signals.

With the latest GNP report for the first quarter, the Commerce Department released revised profit figures. At first glance, the improvement looks very impressive. Domestic profits were up 25% year-over-year, while foreign profits fell.

However, these profit gains — all operating profits — were very unevenly distributed. For obvious reasons, the financial sector fared best with a profit gain of 39.6%. Still, non-financial profits were also up a strong 22.5%. But these gains were centred in two areas of the manufacturing sector — automobiles and chemicals. Most of these gains did not result at all from higher profit but from the fact that the automobile industry cut its losses from a staggering \$14.9 billion in the first quarter of 1991 to a modest \$1.9 billion in the same quarter of 1992. Understandably, we are not overwhelmed by these profit trends.

A look at the calculated earnings of the various stock indexes listed each week in Barron's supports the same conclusion. What we see there, based on the latest available figures, is an outright profit disaster. Compared to a year ago, earnings per share on the S&P 500 have declined from \$20.99 to \$16.19 (see graph on the next page), on the S&P Industrials from \$23.72 to \$16.91, and on the Dow Jones Industrials from \$150.68 to \$48.13. In the case of the Dow Jones Transports, losses per share have skyrocketed from \$1.45 to \$30.06. These, by the way, are recorded profits. Yet, dividend payments have risen sharply.

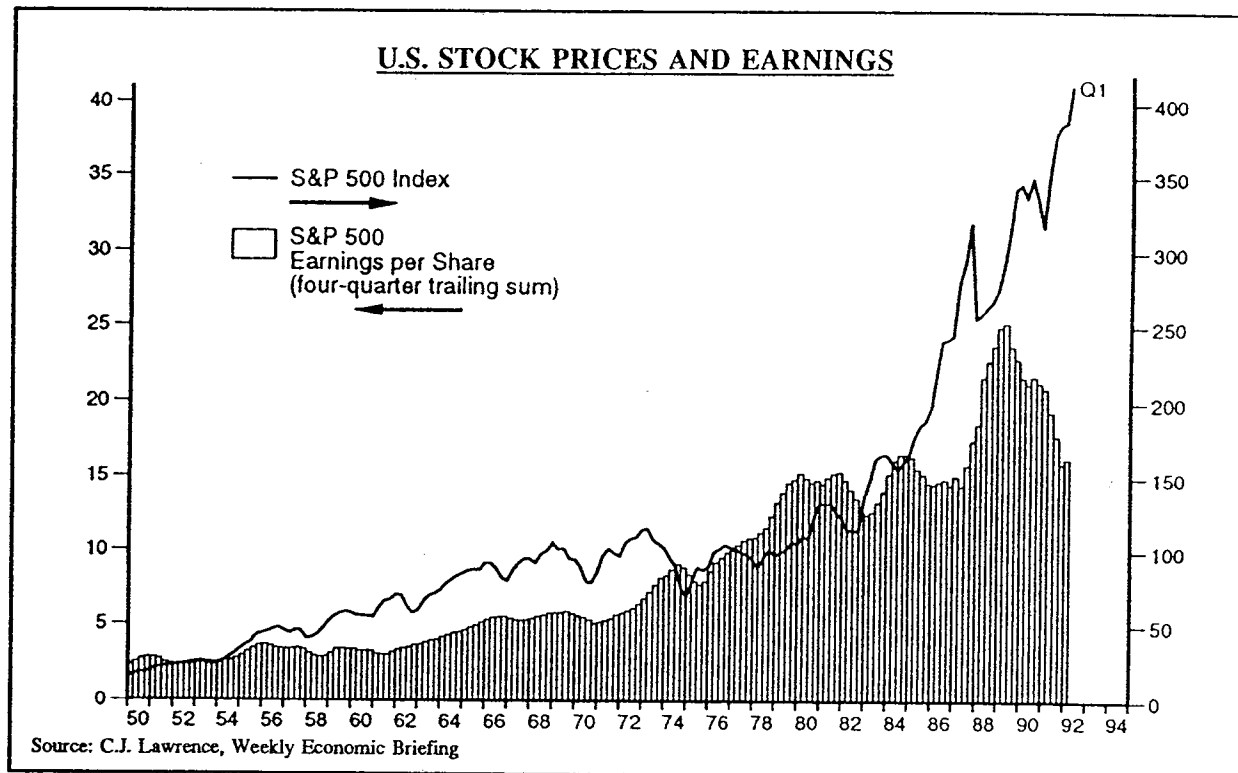
A stimulus to business investment can come from rising demand or from rising profits. In the United States, we see sufficient basis for neither.

### MONEY AND CREDIT: A NECESSARY COMPANION TO RECOVERY

Searching for the foundation of an U.S. recovery, we need to review our other most important gauge: money and credit growth. Accelerating money and credit growth is an absolutely indispensable condition for any recovery. There has never been an exception. What's the latest news on this topic? In short, conditions are going from bad to worse. For the last reporting period ending June 22, both M2 and M3 plunged \$10 billion each.

The end of February proved to be the reversal point this year. During the prior three months, M2 and M3 grew at 5.1% and 3.2%, respectively, both taken at annual rates. During the following three months, M2 gained a mere 0.4% while M3 shrank 1.3%. Taken over the last 12 months, M2 is up 1.9% and M3 just 0.1%. Such monetary weakness is unprecedented.

Quite understandably, the Fed and many others don't want to take this money data seriously. If money matters, these figures make terrifying reading. The overwhelming reaction, therefore, has been to explain



them away. The general nonchalant argument — ignoring broad money and credit — is that all of the financial indicators that typically lead economic upturns have responded strongly to the Fed's ease. For relief, all you need to do is take comfort from the soaring bank reserves, the strong growth in narrow money (M1), the buoyant stock market and the exceptionally steep and unprecedented yield curve. It's claimed that all of these elements suggest that the Fed's easing is having its desired effects. Shouldn't that be conclusive evidence of a monetary easing that's highly effective?

No. None of the indicators above offer any such proof. In general, what's really reflected is the Fed's desperate pumping efforts. Just what is being accomplished with these aggressive measures is the key question, and one only the money and credit aggregates alone can answer. The persistent weakness of money and credit tells us that the monetary easing is fizzling out in the financial system without reaching the real economy. What counts for the real economy is not a rise in bank reserves or a steep yield curve, but the amount of money that the banks actually put into circulation by lending. That alone is the decisive effect of monetary easing.

Earlier this year, when M2 spurted, it was immediately seized upon as hard proof of a recovering economy. To us, though, it clearly looked like a statistical freak because bank lending stayed put. To date, that remains the case. The only thing worth mentioning about the U.S. banking system is that the foreign banks, which had still strongly expanded until the end of last year, are now also treading water.

Here are the overall money figures that, in our view, explain everything: During the past 12 months until the end of May, all commercial banks, including foreign-related institutions, increased their holdings of government bonds by \$113.8 billion or 23.4% while total loans and leases to the private sector stagnated. More recent data shows even slower overall growth. Since the end of 1991, net bond purchases have

amounted to \$36.4 billion while loans have contracted by \$6 billion. All this is unimpeachable confirmation that the extraordinary weakness in the U.S. monetary aggregates is for real.

The U.S. economic recovery — never much to begin with and really just a temporary growth spurt — is now rapidly fading. The persistent, if not worsening, weakness in the broad money aggregates will increasingly act as a drag on not only the economic recovery and business profits but also the asset markets despite another interest rate cut by the Fed. Wall Street, of course, by condition of Pavlovian reflex, is buoyed by every new interest rate cut even though none has so far stimulated the real economy. This decoupling of the financial markets from the underlying economy can only go on so long. What isn't being realized is that the main causes of this recession — a profit and income squeeze and overindebtedness — are not being resolved. Financial markets, therefore, remain horribly overvalued and vulnerable.

### **THE FALLACIOUS CASE FOR A DOLLAR RALLY**

The big problem — especially for international investors — is the outlook for the U.S. dollar. The dollar bulls remain in the great majority; in Europe perhaps even more so than in the United States. As far as we can see, the bulls cite three main arguments to support their trenchant bullish view: the international business cycle, Germanosclerosis and purchasing power (PPP).

The one and only theory that we have always agreed with, is that the international business cycle has been the surest influence on the dollar-DM exchange rate. In general, the dollar has gained strongly when the U.S. economy pulled out of recession sooner or faster than the rest of the world. That was a regular feature of the international business cycle as rising U.S. interest rates pulled capital in from abroad. Capital flows are essentially more variable and responsive than trade flows.

This cyclical concept, coupled with the assumption that German interest rates must fall due to a weakening economy, has been the main reasoning behind the persistently bullish dollar forecasts since early last year. From the beginning, we have judged these suppositions to be completely wrong.

The key flaw in the consensus conception about the dollar was, of course, the optimistic view on the U.S. recovery and its impact on U.S. interest rates. Even if the U.S. economy does not slide back into recession, as we think it will, the economy is in any case too fragile to allow any monetary tightening as far as the eye can see.

Equally mistaken are the assumptions about an early easing by the Bundesbank. Despite strong international pressure on the Germans to lower interest rates, no easing is in sight before 1993. There is no chance of any loosening — let alone even the posturing of easing — until money supply growth slows sharply. Actually, M3 growth, presently around 9%, remains so far above its target range of 3.5-5.5% that it may eventually trigger renewed speculation about a rise in DM interest rates. For the Bundesbank, its credibility is at stake. It may well be up to currency markets whether it will raise its interest rates further or not.

Consequently, we don't see how the large dollar-DM interest rate gap can narrow anytime soon. Besides, we strongly disagree with the consensus view that all that's needed to put the dollar on a sustained upward path (barring temporary speculative bursts) is a mere narrowing of the existing large dollar-DM interest rate spread. What if the D-mark maintains a more permanent interest rate advantage against the dollar,

reflecting greater dynamism of the German and European economy than the U.S. economy?

We actually think that will happen. We wonder how it will impact the dollar-DM exchange rate over the long term. Ever since the early 1970s (see graph on page 4), it was the D-mark that had the lower interest rates of the two currencies. Nevertheless, the D-mark held up very well. So, why shouldn't the dollar? There's an important difference. Germany is a surplus country; the United States is a deficit country. Even then, the D-mark was often pretty weak. It has yet to be explained to us how a deficit country over the long run can live with the lowest interest rates in the world and still have a strong currency.

The dollar bulls have a magical incantation with which they counter any such earthly considerations: PPP — the Purchasing Power Parity.

### **THE DOLLAR AND PPP**

The PPP theory has had its ups and downs over the years ever since it was invented in the early 1920s. Interest in the theory always flared up when people believed that existing exchange rates were unrealistic. Basically, the theory assumes that the demand for currencies is determined by domestic purchasing power over the long run.

As for the U.S. dollar, the PPP argument says that it is fabulously cheap in terms of what it can buy in America . . . in other words, undervalued. According to popular calculation, the dollar is said to be undervalued against the D-mark and the yen by about 35%. This "cheapness," so goes the conclusion, will boost the dollar over time even against the downward pull of high foreign interest rates.

It seems that the PPP has found many adherents in the currency markets. We hear and read about the PPP argument constantly; it may well have played an important psychological role in supporting the dollar so far. For a large number of investors, a "cheap" and "undervalued" dollar is seen to be synonymous with "cheap" and "undervalued" dollar assets. We already showed that isn't the case.

In our view, the PPP theory is grossly misleading in every respect. It is apt to lead to wrong conclusions both about the U.S. trade balance and the capital account. For example, it is another common view to believe that U.S. industry is highly competitive in the world at the present U.S. dollar exchange rate. To most observers, the drastic shrinkage of the U.S. trade deficit from \$159 billion in 1987 to the present \$60-70 billion is infallible testimony of rising U.S. competitiveness.

We really hate to contradict all the time, but it's clear to us that there is a powerful cause at work behind the trade deficit reduction that has little to do with competitiveness or an undervalued dollar: a dramatic reversal in international demand conditions — slumping U.S. demand versus strong demand in the rest of the world. Taking these divergent developments into account, America's trade improvement can only be seen as unimpressive. On the contrary, it's ominous that trade remains mired in a large deficit even in face of a long recession. In Japan, by contrast, an encroaching recession has caused its trade surplus to soar.

In our time of high technology, the argument of PPP boosting the dollar is a sheer anachronism. The crucial variable for competitiveness is productive investment. What is ailing the U.S. trade balance and the dollar and will be an increasingly plague over the long run, is a sharp decline in the U.S. manufacturing stock relative to that of the main competing countries.

We note with interest that a recent study published by the Federal Reserve Bank of New York (Quarterly Review, Winter 1991-92, Explaining the Persistence of the U.S. Trade Deficit in the Late 1980s) comes to the same conclusion as ours. It stresses depressed U.S. capital stock investment relative to investment abroad as the key cause for a "*secular decline in U.S. competitiveness*." We couldn't agree more.

### THE MAASTRICHT MUDDLE

Three cheers and many thanks to the Danes who put the boot to the Maastricht treaty. We are in full agreement with the biting remarks of David Fuller (Fullermoney 97) about the treaty and its originators: "*Maastricht revealed the arrogance of EC officials and several European state leaders, who were trying to cobble together a federal superstate as a monument to their egos and collective folly. Most of the ministers pushing for European monetary union (EMU) are lame ducks, anxious to leave a few footprints in the sands of time.*"

Our conclusion has always been that the risks and disadvantages of a common currency far outweigh the advantages. It's an economic and political folly complicated by the messy reality of 12 independent states with widely differing economic structures, performance and priorities.

Bad economics is always bad politics. The most obvious aspect to question is the simplistic notion that a common currency unites people. We don't see any evidence of that elsewhere. What about the hostility between the Flemings and Wallones in Belgium, the east and west Germans who quarrel more than ever since they've formed a single currency, and what about the French Canadians? The key point of contention, though, is inflation. If, as a result of a single currency, the Germans find themselves hamstrung with more inflation than before, an outcome that is virtually certain, one can be sure that they will curse Europe forever.

The bureaucrats wax poetic about "Europe," but their real agenda concerns power. The Maastricht treaty is really about who will set Europe's monetary policy. Now, Europe has a monetary policy set by the Bundesbank, Europe's best central bank. But others, including such French politicians as Mitterand and Giscard d'Estaing, are not content to see France playing second fiddle. They prefer a softer European currency to the present "france fort" dominated by the Bundesbank.

The common currency idea has been sold to Europeans buttered with two promises that will never be kept: the hard currency constituencies are lured with the promise that EMU will produce a new currency that's as stable as the present national currencies; the people of the poorer countries are bribed with the sweetener of mega-million presents from the rich countries. To get some idea of what's happened here just imagine that some bureaucrats in Washington without Congress decide that the rich states are obliged to raise the living standards in the poorer states through higher budget transfers. And, of course, the bureaucrats alone are deciding the distribution of the money.

In closing, we can't resist a few words about the politics of the situation. Writing from Frankfurt, what annoys us even more than the economic malarkey of the whole thing, is the insolence of those politicians whose mouths are full of the word "Europe." When it comes to the Yugoslav massacres on Europe's doorsteps, the Community and its leading politicians in Germany, France, and Britain have not only appeared helpless, they have encouraged the mass murder by their foolish declarations of non-intervention. They seem neither shocked nor ashamed. What does Yugoslavia have to do with Maastricht? Well, both have to do with the character and competence of Europe's politicians. That's a point that should be kept

in mind when addressing the economic and financial aspects of Maastricht and EMU, of which we plan to do more in next letters.

## CONCLUSIONS

Hopes of an U.S.-led world recovery has begun to crumble fast in the last few weeks. What's worse, the Japanese economy, too, reveals signs of a sharp slowdown. Among the industrialized countries, Europe shows the greatest resilience, Britain being the most disastrous exception.

The U.S. dollar is drifting inexorably lower with nothing in sight that could possibly halt its slide. We don't think markets have yet discounted the prospect of a "triple dip" recession in the U.S. or the uncertainties of the Presidential election. Dollar weakness is of little concern to the Fed or the Bundesbank as long as it doesn't turn into a collapse. Businesses should have long ago hedged any dollar exposure.

Considering the continued rapid money and credit growth in Germany (9% and 12%, respectively), under normal conditions the Bundesbank would have to tighten now. The obstacle is the poor state of the world economy. But, as we have said, the large dollar-DM rate differentials are not only a cyclical symptom. They are an early sign of deep secular changes. Long-term growth potentials have moved in opposite directions: Germany's is up to 3.5%, America's is down to 2%. As a result the German economy is able to bear much higher interest rates than the U.S. economy.

The last couple of quarters have demonstrated that getting the currency right is more important than anything else. Given an environment of sluggish world economic growth and a weak dollar, strains in the European rate system are bound to increase. As such, we must narrow our recommendation of hard-currency bounds to those of Germany only. The greatest safety, of course, would be found in shorter-term bonds.



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